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DAMAGES IN SECURITIES LITIGATION

PLAINTIFFS' STRATEGIES FOR A DEFENSIBLE DAMAGES STUDY

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INTRODUCTION

Over the last twenty-five years, damages calculations in securities class actions have become increasingly more complex and sophisticated. Starting from a relatively basic analysis to highly intricate event studies, defendants have sought to require plaintiffs to provide damage models that more accurately reflect the various factors impacting a company's stock price movement. With the United States Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo,*[2] plaintiffs must now show that defendants' material misrepresentation or omission was the cause of plaintiff's loss, and not the result of an intervening event. As a result, the need and use of event studies to show loss and damages have become a vital part of a plaintiff's case. This article will address the current case law setting forth the requirements for plaintiffs in providing a comprehensive damages analysis such that plaintiffs can meet the burden of establishing damages in a securities fraud class action.

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[2] 544 U.S. 336 (2005).

What is Loss Causation?

Loss causation "is the casual link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff."[3] At its base, "loss causation is nothing more than a securities fraud analog to the tort concept of proximate causation, 'meaning that the damages suffered by plaintiff must be a foreseeable consequence of any' scheme to defraud."[4]

In *Dura*, the Supreme Court held that to plead loss causation under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"),[5] 15 U.S.C. § 78a, *et. seq.*, a complaint must allege more than that securities at issue were purchased at an artificially inflated price.[6] Plaintiff must also provide defendant with some indication of the causal connection between the loss and the alleged misrepresentation. It is not enough for a plaintiff to merely allege that, at the time of plaintiff's purchase of a security, the price of that security was artificially inflated as a result of a defendant's misrepresentation.[7] Instead, a plaintiff "may do one of two things to sufficiently allege loss causation. 'Where the alleged misstatement conceals a condition or event which then occurs and causes the plaintiff's loss,' a plaintiff may plead that it is 'the materialization of the undisclosed condition or event that causes the loss.' Alternatively, a plaintiff may

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[3] *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003).

[4] *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 245 F.R.D. 147, 160 (S.D.N.Y. 2007) (quoting *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 186 (2d Cir. 2001)).

[5] Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder prescribes the making of "any untrue statement of a material fact" or the omission of any material fact necessary "to make the statements made … not misleading." 15 U.S.C. §78a *et. seq.*, 17 CFR § 240.10b-5 (2004).

[6] 544 U.S. at 347.

[7] *Gordon Partners v. Blumenthal*, No. 02 Civ. 7377, 2007 U.S. Dist. LEXIS 9110, at *39 (S.D.N.Y. Feb. 9, 2007)

identify particular 'disclosing event[s]' that reveal the false information, and tie dissipation of artificial price inflation to those events."[8]

For example, in *In re Apollo Group, Inc. Securities Litigation*, the court found that *Dura's* loss causation requirements were satisfied where plaintiff alleged that defendants' disclosure of information relating to the Department of Education ("DOE") program review caused the stock-price to decline.[9] In *Apollo*, plaintiffs alleged that defendants kept the company's stock artificially high during the class period by misrepresenting the status of a DOE program review at the University of Phoenix (Apollo's wholly-owned subsidiary). Plaintiffs further alleged that the failure to disclose the contents of the DOE report rendered certain public statements made by defendants during the class period false and misleading. On September 7, 2004, before the DOE issued a final determination in the program review, the University of Phoenix agreed to pay $9.8 million to the DOE to settle the program review.[10] Shortly thereafter, news of the allegations contained in the DOE report was made public for the first time in a series of analyst reports.[11] As a result, Apollo stock fell significantly.

Proving actual loss is crucial to a plaintiff's case: "it should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind."[12]

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8 *Catton v. Defense Tech. Sys.*, No. 05 Civ. 6954, 2006 U.S. Dist. LEXIS 205 at *22 (S.D.N.Y. Jan. 3, 2006) (quoting *Liu v. Credit Suisse First Boston Corp.* (*In re Initial Pub. Offering Secs. Litig.),* 399 F. Supp. 2d 298, 307 (S.D.N.Y. 2005)).

9 509 F. Supp. 2d 837, 838-40 (D. Ariz. 2007).

10 *Id.* at 838-40.

11 *Id.* at 840.

12 *Dura*, 544 U.S. at 347.

"For example, [to show loss causation] the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement or omission."[13] However, "if the loss was caused by an intervening event, like a general fall in the price of Internet stocks, the chain of causation will not have been established." [14] Therefore, plaintiffs must provide evidence showing that their losses are a result of inflation in defendant's stock price caused by defendant's misstatements or omissions. Thus, the use of event studies has become an integral part of showing loss causation and damages in securities fraud cases.

How Are Damages Calculated? What Is An Event Study?

A plaintiff's damages in a securities fraud case are usually calculated as the out-of-pocket loss that was suffered.[15] The out-of-pocket loss is measured by the difference between the price at which the stock sold and the price at which the stock would have sold absent the artificial inflation in the stock price caused by the alleged misrepresentations or omissions.[16] Although the measure of damages is well-established, actually determining the amount of damages is much more difficult. Older authorities simply fixed the damages as the difference between the price paid for the securities and

[13] *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281, 373 n. 134 (S.D.N.Y. 2003) (citation omitted).

[14] *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d at 197 (2d Cir. 2003).

[15] *In re Credit Suisse First Boston Corp. Sec. Litig.*, No. 97 Civ. 4760, 1998 WL 734365, at *12 (S.D.N.Y. Oct. 20, 1998)("Out of pocket damages are the typical measure of damages awarded in securities fraud cases brought under § 10(b) and Rule 10b-5. They are measured as 'the difference between the purchase price and the true value of the stock.'") (citation omitted).

[16] *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154-55 (1972).

the value of the securities determined as of the time of the discovery of the fraud.[17] This methodology was met with opposition from defendants, because it ignored factors impacting stock price, such as overall economic and industry factors, that were unrelated to any possible fraud.[18]

In *Green v. Occidental Petroleum Corp.*, Judge Sneed's concurring opinion set forth a theory for measuring damages that proved to be a landmark.[19] Judge Sneed suggested that in a securities fraud class action, the best way to measure the loss proximately caused by a misrepresentation of a defendant is to create a chart containing a "price line" and a "value line."[20] Damages would then be calculated by subtracting the true value of the stock on the date of the purchase from the price actually paid, with the spread between the price and the value lines varying over time.

As courts began to adopt Judge Sneed's "value line" concept, an issue arose as to the best methodology for determining a stock's "true value." A methodology that began gaining some measure of acceptance was the use of an "event study" to determine true value.[21] An event study is a statistical regression analysis that examines the effect of an

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[17] *See Esplin v. Hirschi*, 402 F.2d 94, 104-05 (10th Cir. 1968) (court held the defrauded buyer is entitled to recover the difference between the price paid for the securities and the value of the securities as of the time of discovery of the fraud); *Harris v. Am. Inv. Co.*, 523 F.2d 220, 226-27 (8th Cir. 1975) (appropriate date for ascertaining damages sustained to stockholder as result of a violation of securities laws prohibiting publishing of false and misleading statements and filing of false and misleading information was the date of public discovery of the fraud).

[18] Eisenhofer, Jarvis, and Banko, *Securities Fraud, Stock Price Evaluation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation*, 59 Bus. Law. 1419 (2004).

[19] 541 F.2d 1335, 1341 (9th Cir. 1976).

[20] *Id*. at 1344.

[21] *See, e.g., In re Oracle Sec. Litig.*, 829 F. Supp. 1176, 1181 (N.D. Cal. 1993) (requiring use of an event study or similar analysis to more accurately isolate the influences of information specific to the Company which defendants allegedly distorted).

event on a dependent variable, such as a corporation's stock price.[22] Event studies are employed to argue that (1) an alleged misrepresentation was or was not material; (2) the misrepresentation did or did not cause any loss to the plaintiff; and (3) if the misrepresentation caused a loss, a measureable part of the loss was due to the fraud, with the rest due to other factors that also affected the stock price.[23] This approach assumes that the price and value of the security move together except during the days when disclosures of company-specific information influence the price of the stock.[24] The damages expert then looks at the days when the stock price moves differently than anticipated solely based upon market and industry factors, so called days of "abnormal returns." The damages expert determines whether those abnormal returns are due to fraud or non-fraud related factors.[25]

Over time, the majority of courts have recognized the utility of the event study methodology and have begun to require experts to include an event study with their damage report because of the need "to distinguish between the fraud-related and non-fraud related influences on the stock's price behavior."[26] Courts have held that the event study method is "an accepted method for the evaluation of materiality damages to a class

[22] *RMED Int'l, Inc. v. Sloan's Supermarkets, Inc.*, No. 94 Cir. 5587, 2000 WL 310352, at *6 (S.D.N.Y. Mar. 24, 2000) (citing Jon Koslow, *Estimating Aggregate Damages in Class-Action Litigation Under Rule 10b-5 for Purposes of Settlement*, 59 Fordham L. Rev. 811, 822 & n.50 (1991)).

[23] Fisher, *Does The Efficient Market Theory Help Us Do Justice In A Time Of Madness?*, 54 Emory L.J. 843, 871 (2005).

[24] *See, e.g.*, *RMED*, 2000 WL 310352 at *6-7.

[25] Cornell & Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 UCLA L. Rev. 883, 899-900 (1990).

[26] *In re Oracle Sec. Litig.*, 829 F. Supp. at 1181.

of stockholders in a defendant corporation."[27]

A number of courts have even rejected or refused to admit into evidence damages reports or testimony by damages experts that fail to include event studies, or something similar. In *In re Northern Telecom Ltd. Securities Litigation*, the court held that the testimony by plaintiff's expert was "fatally deficient in that he did not perform an event study or similar analysis to remove the effects on stock price of market and industry information and he did not challenge the event study performed by defendants' expert."[28] Similarly, in *Oracle* the court rejected a plaintiff's expert report for failure to perform an event study. The *Oracle* court held that the "use of an event study or similar analysis is necessary more accurately to isolate the influences of information specific to Oracle which defendants allegedly have distorted."[29] In the recent case of *Gordon Partners v. Blumenthal*, the court granted summary judgment for the defendants because "plaintiffs have not provided the Court with an event study or any similar analysis of their damages… the Gordon plaintiffs have not provided this Court with any evidence as to what their true damages are and therefore cannot show loss causation."[30]

Courts have even rejected event studies that do not comply with basic principles of corporate finance and include as damages only those factors that are related to the fraud.[31] In the recent case of *In re Omnicom Group, Inc. Securities Litigation*, the court

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[27] *In re Gaming Lottery Sec. Litig.*, No. 96 Civ. 5567, 2000 WL 193125, at *1 (S.D.N.Y. Feb. 16, 2000). *See also In re Imperial Credit Indus. Sec. Litig.,* 252 F. Supp. 2d 1005, 1014 (C.D. Cal. 2003); *In re Oracle Sec. Litig.*, 829 F. Supp. at 1181.

[28] 116 F. Supp. 2d 446, 460 (S.D.N.Y. 2000).

[29] *In re Oracle Sec. Litig.*, 829 F. Supp. at 1181.

[30] *Gordon Partners*, No. 02 Civ. 7377, 2007 U.S. Dist. LEXIS 9110 at *44.

[31] *See, e.g., In re Executive Telecard, Ltd. Sec. Litig.*, 979 F. Supp. 1021 (S.D.N.Y. 1997).

rejected plaintiff's expert's event study on multiple grounds. "First, … the event study at best incorrectly identifies several corrective disclosures and at worst fails to identify any at all. Second, to the extent that any corrective disclosures exist, the event study does not isolate their effect on Omnicom's stock price from that of the negative reporting, which dwarfed any shreds of new information disclosed… "[32] Thus an event study is required to exclude factors from the overall economy, such as an overall market decline, factors impacting the relevant industry, and factors related to the specific company that are not fraud related.[33] In fact, many defense experts have made extensive use of this last requirement, parsing every announcement by a company to attempt to isolate factors that negatively impacted the stock price, but which are not related to the alleged fraud.[34]

What Are The Data Resources For An Event Study?

Event studies are primarily comprised of readily available information. This includes *inter alia*, SEC filings, press releases, news reports, analyst reports, stock

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[32] *In re Omnicom Group, Inc. Sec. Litig.*, No. 02 Civ. 4483, 2008 U.S. Dist. LEXIS 6033, at *22-23 (S.D.N.Y. Jan. 29, 2008) (Plaintiffs were unable to allege facts sufficient to support a corrective disclosure associated with a negative market reaction to the disclosures, rather than to other information simultaneously released to the market).

[33] *See, e.g., Stuebler v. Xcelera.com (In re Xcelera.com Sec. Litig.)*, 430 F.3d 503, 513-14 (1st Cir. 2005) (here the court found plaintiff's event study reliable, where the expert "submitted an event study which 'sought to identify all or nearly all of the news and information' pertaining to Xcelera - whether 'statistically significant' or not – 'in the form of published articles, press releases, reports, news bulletins and financial filings of Xcelera,' for the proposed Class Period." Plaintiffs' event study listed more than forty separate instances, thirty-six of which occurred during the Class Period, in which Xcelera stock price rose or fell (in several cases, by more than 50%, and in one case, rose by more than 100%) within one day of the release of company-specific information.)

[34] *See, e.g.*, *In re WorldCom, Inc. Sec. Litig.*, 219 F.R.D. 267, 299 & n.42 (S.D.N.Y. 2003) (defendant's expert, in analyzing market price movements, SEC filings, analyst reports, and news reports, argued that plaintiffs' Amended Complaint did not demonstrate a causal link between Grubman's analyst reports and movements in the price of WorldCom securities. Plaintiffs' expert responded with an event study identifying "eighteen instances during the Class Period in which Grubman's analyst reports introduced new or unanticipated information into the market" to show that Grubman's reports caused subsequent changes in WorldCom's stock price).

quotes, market indices, and industry indices. The information from these sources is combined to show that the price and the value of the stock move together, except on days in which there is a release of company-specific information that influences the price of the stock. The event study must then determine whether those abnormal returns are due to fraud or non-fraud related factors. Moreover, the event study methodology is actually used by financial economists as a tool to measure and predict the effect on market prices from all types of new information relevant to a company's stock valuation.[35] Therefore, plaintiff's event study must show "facts indicating the presence of an *actual and quantifiable* relationship between the alleged fraud and the decline of the stock price."[36]

In *Executive Telecard*, the court rejected two different event studies done by plaintiffs' expert, concluding that the methodologies to evaluate both company risk and market risk were "seriously flawed."[37] The first was rejected for failure to indicate whether the expert conducted an event study to determine whether the company's stock price was affected by company specific factors exclusive of the challenged fraud.[38] Second, in addressing the market risk factors, the expert relied exclusively on the Telecom index, which did not have meaningful correlation with the company's stock price because the company was far more volatile than the stocks which comprised the Telecom Index.[39]

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[35] *See*. Bizjak & Coles, *The Effect of Private Antitrust Litigation on the Stock Market Valuation of the Firm*, 85 Am. Econ. Rev. 436 (1995).

[36] *In re Intelligroup Sec. Litig.*, 468 F. Supp. 2d 670, 693-94 (D.N.J. 2006) (emphasis in original).

[37] *In re Executive Telecard*, 979 F. Supp. at 1025.

[38] *Id.* at 1025.

[39] *Id.* at 1027-28. The *Executive Telecard* court explained: "In contrast to the highly capitalized companies like AT&T and MCI included in the Telecom Index, a 'small-cap' stock like [Executive

CONCLUSION

In preparing a defensible damages analysis, plaintiff's expert must identify a disclosure by defendant that causes defendant's stock price to decline. Plaintiff must establish that defendant's material misrepresentation or omission during the period of the fraud is the cause of plaintiff's loss. In establishing such, plaintiff's expert must prepare an event study and factor in every company-specific event that might have affected the defendant's stock price during the period of the securities law violation – distinguishing between fraud-related and non-fraud related influences on the stock price. Finally, plaintiff's expert must compare defendants' stock price movements with price movements of market or industry indices "fairly representative of the way in which [defendants' stock] would have traded absent the alleged fraud."[40]

Telecard] does not trade on reported earnings per share, but instead moves in accordance with the market's expectations and perceptions of its long term economic prospects. Euphemistically, [defendant's] stock could be said to trade on 'hope.'" *Id.* at 1028 n.3.

40 *RMED*, 2000 WL 310352 at *9.